APPENDIX A

A-1

60 T. C. No. 11
UNITED STATES TAX COURT

NATHAN CUMMINGS and JOANNE T. CUMMINGS,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 2653-71. Filed April 23, 1973.

P was a director and shareholder of MGM, and in 1962 he made a payment to MGM of $53,870.81 when the SEC indicated that P might be liable to MGM for such amount as an insider's profit within the meaning of sec. 16(b) of the Securities Exchange Act of 1934. *Held,* under the particular circumstances of this case, the payment is an ordinary and necessary business expense of P.

ANDERSON A. OWEN, EDWARD W. ROTHE, and GLEN H. KANWIT, *for the petitioners.*
NELSON E. SHAFER, *for the respondent.*

SIMPSON, *Judge*: The respondent determined a deficiency of $45,790.18 in the petitioners' Federal income tax for 1962. The only issue for decision is whether the petitioner may deduct as a business expense under section 162(a) of the Internal Revenue Code of 1954,[1] or as a business loss under section 165(a), a payment of $53,870.81

[1] All statutory references are to the Internal Revenue Code of 1954, except that any reference to section 16(b) is to such section of the Securities Exchange Act of 1934.

which he made to MGM in 1962 when the Securities and Exchange Commission indicated that he might be liable to MGM for such amount as an insider's profit within the meaning of section 16(b) of the Securities Exchange Act of 1934.

FINDINGS OF FACT

Some of the facts were stipulated, and those facts are so found.

The petitioners, Nathan Cummings and Joanne T. Cummings, are husband and wife, who maintained their residence in New York, New York, at the time their petition was filed in this case. They filed their 1962 joint Federal income tax return with the district director of internal revenue, Chicago, Illinois. Mr. Cummings will be referred to as the petitioner.

During 1962, and since 1940, the principal occupation of the petitioner has been that of chairman of the board and chief executive officer of the Consolidated Foods Corporation (CFC). CFC was founded in 1939 by the petitioner, and it is now a leading processor, canner, and distributor of food products, with present sales of $1.7 billion a year, as compared with sales of $16 million in 1939 and approximately $500 million in 1962.

During 1962, the petitioner was also a director and shareholder of Associated Products, Inc., Rothschild Enterprises, Inc., the College Inn Food Products Co., Monarch Fine Foods, Ltd., Metro-Goldwyn-Mayer, Inc. (MGM), and the Rival Packing Corporation. Prior to 1962, the petitioner was a director and shareholder of the Bon Ami Corporation, the City Stores Company, and the Kay Woodie Company. Sometime subsequent to 1962, the petitioner was a director and shareholder of the Society Corporation, the Western Union Telegraph Company, and the General Dynamics Corporation. As a director, the peti-

tioner attended meetings with directors, executive committees, and corporate officers to help improve on activities of the corporation and see that it was well run at a profit.

In 1959, the petitioner was approached with a proposition to purchase a large block of MGM stock. He was told that the corporation was having problems and that if he would become a director, 3 directors who were involved in controversy would resign. Subsequently, the petitioner purchased 51,500 shares of MGM stock at a minimum total cost of $1,030,000, the 3 directors resigned, and the petitioner was elected as 1 of the 15 MGM directors. His purpose in becoming an MGM director was to make a profit by improving MGM's performance. As a director, the petitioner participated actively in MGM's corporate affairs by attending board meetings, by giving the benefit of his judgment on corporate affairs, and by inspecting the corporate properties to determine how they might be better managed.

On April 17, 1961, the petitioner sold 3,400 shares of MGM stock for a total of $227,648.28. The gain realized by the petitioner on this sale was reported as a long-term capital gain on his 1961 Federal income tax return, along with the gains from other sales of MGM stock in March 1961. On various dates from September 18 through October 2, 1961, the petitioner purchased a total of 3,000 shares of MGM stock for a total of $146,960.89. The petitioner was an MGM director throughout 1961.

On January 16, 1962, the Division of Corporation Finance of the Securities and Exchange Commission (SEC) wrote a letter to the secretary of MGM giving its comments on the preliminary material soliciting proxies which MGM had prepared for the annual MGM stockholders meeting to be held on February 23, 1962. It noted that the petitioner

had purchased 3,000 shares of MGM stock during September and October of 1961, after having sold a like number within the previous 6 months, and that if he realized:

> any material profits from these transactions which under Section 16(b) of the Securities Exchange Act of 1934 inure to and are recoverable by the issuer, the pertinent facts with respect to these transactions should be disclosed in the proxy statement • • •

Section 16(b) of the Securities Exchange Act of 1934 prohibits an "insider," such as a corporate director, from buying and selling or selling and buying, within a 6-month period, the stock of a corporation in which he is an insider. If such a transaction occurs and results in a profit, the corporation should either be paid the profit (commonly known as the "insider's profit") or it should show the profit on its annual report as a debt owed to the corporation. 15 U.S.C. sec. 78p(b) (1971). The difference between the selling and buying price in this case was $53,870.81.

Upon receipt of the SEC letter, the secretary of MGM immediately informed the petitioner of its contents. The petitioner believed that if any section 16(b) violation had occurred, it had been solely the result of inadvertence. However, so as not to delay the issuance of MGM's proxy statement and so as to avoid the impact which disclosure of his potential section 16(b) liability might have on his business reputation, the petitioner immediately decided to pay MGM $53,870.81. The payment was made on the following day, and as a result, MGM was able to print its proxy statement, which was dated January 18, 1962, without any reference to the insider's profit problem.

On February 1, 1962, the petitioner received from his personal financial assistant a memorandum calling his attention to a situation in which a corporation did not

require the insider to make a payment of his section 16(b) profit to the corporation because the violation was inadvertent. On the basis of such memorandum, the petitioner wrote to the secretary of MGM on February 6, 1962, to request a refund of the $53,870.81 payment which he had made. The matter was referred by MGM to independent counsel for an opinion, and such counsel recommended that MGM not make the refund. No refund was ever made.

In 1962, the petitioner received $100,000.16 as his salary from CFC, $89,512.00 in dividend income from his MGM stock, and $5,000.00 in director's fees from MGM. He received no other director's fees during 1962.

On their 1962 joint Federal income tax return, the petitioners deducted the $53,870.81 payment to MGM as an ordinary loss, and the respondent determined that such loss was a long-term capital loss.

OPINION

The only issue for decision is whether the petitioner is entitled to deduct the payment which he made to MGM as a business expense under section 162(a) or as a business loss under section 165(a).

This issue first came before this Court in *William L. Mitchell,* 52 T.C. 170 (1969). In that case, the taxpayer was a corporate vice president who had allegedly violated section 16(b), and we found that he was in the trade or business of being a corporate executive and that he made a payment of his alleged insider's profit to the corporation so as to avoid injury to his business reputation, embarrassment to his employer and himself, and the expense of future litigation. We, therefore, held that the payment constituted an ordinary and necessary expense of the tax-

payer's trade or business. Our decision in *Mitchell* was reversed by the Court of Appeals for the Sixth Circuit. 428 F. 2d 259 (C.A. 6, 1970), cert. denied 401 U.S. 909 (1971).

The issue arose again in *James E. Anderson*, 56 T.C. 1370 (1971), on appeal (C.A. 7, Dec. 23, 1971), in which we thoroughly reconsidered the bases for our holding in *Mitchell* in the light of the reversal of that decision by the Sixth Circuit. With due respect to the views of that circuit court, we again held that a payment made by the taxpayer on account of his apparent violation of section 16(b) was an ordinary and necessary business expense. The taxpayer was a vice president of the Zenith Radio Corporation, and we found that he was in the trade or business of being a corporate executive, that the obligation to make the section 16(b) payment arose out of his status as a Zenith employee, and that the payment was made to preserve his employment with Zenith and avoid injury to his business reputation.

In urging us to hold that the payment made to MGM constituted an ordinary and necessary business expense, the petitioner contends that he was in a trade or business which included being a director of MGM, that his obligation to make the section 16(b) payment arose out of his status as an MGM director, and that the payment was made to avoid injury to his business reputation and to avoid delay in the issuance of the MGM proxy statement. The respondent concedes that the petitioner's activities, separate from his position with CFC, constituted a trade or business. However, he argues that we should overrule our two prior decisions and apply the doctrine of *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952), and conclude as a

matter of law that the loss was a capital loss. Alternatively, he contends that the present case is distinguishable from *Anderson* and *Mitchell* because it is unreasonable to conclude as a fact that the petitioner had a business purpose in making the section 16(b) payment.

We decline to overrule our prior decisions. This Court thoroughly considered the applicability of the *Arrowsmith* doctrine in *Anderson* and *Mitchell*, and concluded that the doctrine was not applicable because the section 16(b) payment was not directly and integrally related to the earlier sales transaction which gave rise to the capital gain. In *Mitchell*, we noted the lack of any relationship between the amount of the taxable gain or loss recognized on the sale transaction and the amount of section 16(b) profit which inures to the corporation, and in *Anderson*, we noted that the sale which gave rise to the capital gain was made in the taxpayer's status as a shareholder, while his obligation to make the payment arose out of his status as an employee. Similarly, in the present case, there is a lack of correlation between the amount of capital gain recognized on the sale and the amount of the section 16(b) payment, and the obligation to make the payment arose out of the petitioner's status as a director and not out of his status as a shareholder. It is true that the petitioner became a director of MGM to enhance the value of his stock in the corporation, but nevertheless, any obligation to pay MGM the insider's profit arose out of his role as a director.

We also reject the contention that there was no overriding business purpose for making the payment to MGM. In *Anderson*, this Court treated the taxpayer as being in the trade or business of being a corporate executive and found that the obligation to make the payment arose out

of such trade or business and that the payment was made to protect his business reputation. In this case, it is conceded by the respondent that the petitioner was in a trade or business separate from his activities with CFC, and his activities as a director of MGM were clearly a part of that trade or business so that the obligation to make the payment arose out of a trade or business. Thus, in this case, we are not presented with a situation in which being a director was not part of a trade or business of the taxpayer. See *R. Walter Graham, Jr.*, 40 T.C. 14 (1963), revd. on another point 326 F. 2d 878 (C.A. 4, 1964); cf. *Carl F. Fayen*, 34 T.C. 630 (1960); *Stephen H. Tallman*, 37 B.T.A. 1060 (1938).

Furthermore, we find that the payment was made to protect the business reputation of the petitioner and to avoid delay in the issuance of the MGM proxy statement. The respondent suggests that the petitioner made the payment merely because he was required to do so as a matter of law and contends that the disclosure of an apparently innocent violation of section 16(b) would not have blemished the petitioner's business reputation. Yet, the petitioner could not control the reporting of the circumstances to the business community; and it was not unreasonable for the petitioner to believe that his business reputation, which he considered to be his most important asset, might be damaged by incomplete reporting, by people not completely understanding the circumstances, or by mere association with an alleged securities violation. In addition, the timing of the events supports the petitioner's statement as to his reasons. Immediately after learning about the problem, he agreed to make the payment to MGM, and clearly there was insufficient time for him to have secured consid-

ered legal advice as to his liability to MGM. If he had made the payment because of a belief that he was required to do so, he surely would have sought such legal advice, and more time would have been required to secure such advice and to make a decision based upon it.

Both payments made to protect a taxpayer's business reputation (*James E. Anderson, supra; William L. Mitchell, supra; Laurence M. Marks,* 27 T.C. 464 (1956); *Paul Draper,* 26 T.C. 201 (1956)), and payments made in settlement of mismanagement claims arising out of the taxpayer's trade or business (*William L. Butler.* 17 T.C. 675 (1951); *Great Island Holding Corporation,* 5 T.C. 150 (1945); *John Abbott,* 38 B.T.A. 1290 (1938)), have been held to be ordinary and necessary business expenses. Furthermore, in *William L. Mitchell,* we allowed a deduction where the payment was made to avoid injury to the taxpayer's business reputation and embarrassment to the involved corporation. For similar reasons, we hold that the payment made in this case is deductible as an ordinary and necessary business expense.

Decision will be entered for the petitioners.

61 T. C. No. 1

UNITED STATES TAX COURT

NATHAN CUMMINGS and JOANNE T. CUMMINGS,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 2653-71. Filed October 2, 1973.

P was a director and shareholder of MGM, and in 1962, he made a payment to MGM of $53,870.81 when the SEC indicated that P might be liable to MGM for such amount as an insider's profit within the meaning of sec. 16(b) of the Securities Exchange Act of 1934. *Held,* under the particular circumstances of this case, the payment is an ordinary and necessary business expense of P; *Nathan Cummings,* 60 T.C. 91 (1973), reaffirmed.

ANDERSON A. OWEN, EDWARD W. ROTHE, and GLEN H. KANWIT, *for the petitioners.*
NELSON E. SHAFER, *for the respondent.*

OPINION

SIMPSON, *Judge*: An opinion was filed in this case on April 23, 1973, 60 T.C. 91. In such opinion, we held that in the circumstances of the case, the petitioner was entitled, by virtue of section 162 of the Internal Revenue Code of 1954,[1] to deduct as an ordinary and necessary business expense a payment made to MGM. Such payment was

[1] All statutory references are to the Internal Revenue Code of 1954, except that any reference to section 16(b) is to such section of the Securities Exchange Act of 1934.

made after an indication that the petitioner might be liable for an insider's profit in violation of section 16(b) of the Securities Exchange Act of 1934, but the Court found that the payment was made to protect the business reputation of the petitioner and to avoid delay in the issuance of the proxy statement. In so holding, we relied on *William L. Mitchell,* 52 T.C. 170 (1969), revd. 428 F. 2d 259 (C.A. 6, 1970), cert. denied 401 U.S. 909 (1971), and *James E. Anderson,* 56 T.C. 1370 (1971), then on appeal to the Seventh Circuit.

Subsequently, our holding in *Anderson* was reversed. *Anderson* v. *Commissioner,* ..... F. 2d ..... (C.A. 7, June 14, 1973). Based on such reversal, the respondent moved for reconsideration of the opinion and to vacate the decision in the case. On July 9, 1973, the respondent's motion to vacate decision was granted in order to stop the running of the period for appeal, and the parties were directed to submit legal memorandums in support of their positions with respect to reconsideration and revision of our opinion. Such memorandums have been filed.

In *James E. Anderson, supra,* we found that there was no connection between the two events—the taxpayer recognized capital gains in his capacity as a shareholder but paid the alleged insider's profit in his capacity as an officer. The Seventh Circuit found that reasoning unpersuasive. It concluded that at all times relevant, the taxpayer acted in one capacity—that of an insider. The court found that the sale and the subsequent payment were inextricably intertwined. Accordingly, under the doctrine of *Arrowsmith* v. *Commissioner,* 344 U.S. 6 (1952), the taxpayer was entitled only to a capital loss. Moreover, the court thought that to allow an ordinary deduction for the payment would frustrate the purpose of section 16(b), and

in reliance upon *Tank Truck Rentals* v. *Commissioner*, 356 U.S. 30 (1958), it believed that the deduction should also be denied for that reason.

We have carefully re-examined our position in the light of the views expressed by the Seventh Circuit, but with due respect to that court, we are not convinced that our position should be changed. Since venue for appeal of this case is in the Second Circuit,[2] we are not required to follow the decisions of the Circuit Courts in *Anderson* v. *Commissioner, supra,* and *Mitchell* v. *Commissioner,* 428 F. 2d 259 (C.A. 6, 1970). *Jack E. Golsen,* 54 T.C. 742 (1970), affd. 445 F. 2d 985 (C.A. 10, 1971), cert. denied 404 U.S. 940 (1971).

Simply stated, the doctrine set forth in *Arrowsmith* is that, without breaching the principle of the annual accounting period, the tax treatment of a transaction occurring in one year may control the tax treatment afforded a second transaction in a subsequent year where both transactions are integrally related. However, for *Arrowsmith* to apply, there must be a relationship between two transactions which is sufficient to require the conclusion that both transactions are parts of a unified whole. *James E. Anderson,* 56 T.C. at 1376. In *Arrowsmith,* the Court found such relationship in part because the payment there at issue would have been offset against the capital gain, had both transactions occurred in the same year. In *United States* v. *Skelly Oil Co.,* 394 U.S. 678 (1969), a sufficient relationship was found because the percentage depletion allowance would have been reduced, had the payment at issue been made in the year income was initially recognized under the claim of right.

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[2] The petitioners maintained their residence in New York, New York, at the time of the filing of their petition in this case.

In the present case, there was no such integral relationship between the sale of stock and the payment to MGM. Had Mr. Cummings made the payment to MGM in the same year as the sale and purchase, there would have been no reason to require that the payment be offset against the gain realized on the sale. When he sold his MGM stock, he sold a capital asset and realized a capital gain. The subsequent purchase of other MGM stock for a lower price does not, as a matter of tax law, provide a basis for reducing or offsetting the capital gain already realized. *William L. Mitchell,* 52 T.C. at 174.

Nor is the capital gain reduced by the payment to MGM. The Seventh Circuit in *Anderson* appears to have assumed that there was a violation of section 16(b) and that the payment was made in satisfaction of a liability resulting from such violation. However, in *Anderson,* and also in the case before us today, there has been no determination that the taxpayer violated section 16(b) or that he was liable under that section to make any payment. As we pointed out before, Mr. Cummings made the payment promptly after learning of the position taken by the Securities Exchange Commission (SEC); he acted without legal advice; and these circumstances indicate clearly that the payment was not made because of a recognition of a legal duty to do so. On the contrary, it is clear that the payment was made for business reasons and for reasons growing out of his responsibility as a director of MGM. He made the payment to protect his business reputation and to avoid a delay in the issuance of the MGM proxy statement. In *United States* v. *Generes,* 405 U.S. 93 (1972), the Supreme Court pointed out that when an individual, who is both a shareholder and an employee of a corporation, makes or guarantees a loan of the corporation, it is

necessary to decide in which capacity he acted. In like manner, it is also necessary to decide whether, when Mr. Cummings made the payment to MGM, he was acting as a shareholder or as a director, and we remain convinced that it was as a director that he decided to make the payment to MGM.

In our opinion, *Tank Truck Rentals* v. *Commissioner, supra,* is not applicable in this case. In that case, the Court denied a deduction for fines paid as a result of the admitted violation of a State law, because allowance of the claimed deduction would have resulted in an immediate and severe frustration of public policy. Each case was to be decided on the basis of its own facts and circumstances (*Tank Truck Rentals* v. *Commissioner,* 356 U.S. at 35; see also *Laurence M. Marks,* 27 T.C. 464, 469 (1956)), and the circumstances here are significantly different from those in *Tank Truck Rentals.* There has been no finding that Mr. Cummings violated the law by his sale and purchase of MGM stock; there was merely the indication by the SEC that he may have done so. This situation is similar to that in *Joseph P. Pike,* 44 T.C. 787, 798-799 (1965), in which we stated that *Tank Truck Rentals* is inapplicable when the payment at issue is not attributable to the violation of the State law but only to the allegation of a violation—in such circumstance, the payment cannot be considered a penalty.

Accordingly, in the circumstances of this case, we believe that the petitioner recognized capital gains as a shareholder, but made the payment to MGM in his capacity as a director. Had the payment been made in the same year as the gain was recognized, it would not have reduced the amount of such capital gain. Thus, *Arrowsmith* v. *Commissioner, supra,* has no applicability in this case.

The respondent's motion for reconsideration and revision of the opinion is hereby denied.

Reviewed by the Court.

Decision will be entered for the petitioners.

TANNENWALD, *J.*, did not participate in the consideration and disposition of this case.

DAWSON, *J.*, dissenting: I respectfully dissent for the reasons stated in my dissenting opinion in *James E. Anderson*, 56 T.C. at 1377-1379. I would follow the reversal of the *Anderson* case by the Court of Appeals for the Seventh Circuit (73-2 U.S.T.C. Par. 9501). See also *Mitchell* v. *Commissioner*, 428 F. 2d 259 (C.A. 6, 1970), reversing 52 T.C. 170 (1969).

FEATHERSTON, QUEALY, GOFFE, and HALL, *JJ.*, agree with this dissent.

DRENNEN, *J.*, dissenting: I did not participate in this Court's consideration of, and decision in, *James E. Anderson*, 56 T.C. 1370, and hence feel less compunction about taking a position contrary to the position we took in *William L. Mitchell*, 52 T.C. 170, than some of my colleagues. I am inclined to agree with Judge Dawson in his dissenting opinion in *Anderson* that the Supreme Court in *United States* v. *Skelly Oil Co.*, 394 U.S. 678, meant that the Code should not be interpreted to permit the equivalent of a double deduction absent a clear declaration by Congress of such intent. I recognize that artful, technical arguments can be made that the Court had different circumstances and different deductions before it in *Skelly Oil* than we have here and, therefore, that case is not controlling here. But I believe that is more wishful thinking than practical analysis of the Court's opinion and that *Skelly Oil* should be

considered controlling here. Such is the view taken by two Courts of Appeals in reversing this Court in *Mitchell* v. *Commissioner*, 428 F. 2d 256 (C.A. 6, 1970), and *Anderson* v. *Commissioner*, ... F. 2d ..... (C.A. 7, June 14, 1973).

While I realize that the proposal I am making is not before the Court in this case, and may never be urged by either a taxpayer or the Commissioner, because a tax benefit in the hand is worth two possible ones in the future, I am still of the view, suggested in my concurring opinion in *Mitchell*, that perhaps the best way to resolve the conflicting legal arguments and equities under circumstances such as here present would be to add the amount repaid because of the threat of section 16(b) of the Securities Exchange Act of 1934 to the basis of the stock purchased and presently held by the taxpayer. Surely the purchase in both the purchase-sale and the sale-purchase transactions is basically responsible for triggering the repayment because of the possible violation of section 16(b) and thus the repayment is tantamount to an additional cost of the purchased stock. This would deny the purported "insider" recognition of his repayment loss until he disposes of the stock, the purchase of which triggered the payment, and the gain or loss on such ultimate disposition will be characterized the same for tax purposes as the gain he realized and had recognized on the sale of his previously held stock.

I recognize that this proposal would not be applicable in circumstances such as those in *United States* v. *Skelly Oil Co., supra*, and *Arrowsmith* v. *Commissioner*, 344 U.S. 6, where no purchase was involved, but that should not prevent it from being applied in circumstances in which it might provide the better solution.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

No. 54—September Term, 1974.

(Argued October 11, 1974 Decided October 31, 1974.)

Docket No. 74-1406

NATHAN and JOANNE T. CUMMINGS,
Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,
Appellant.

Before:

KAUFMAN, *Chief Judge,*
SMITH and TIMBERS, *Circuit Judges.*

Appeal by Commissioner of Internal Revenue from judgment of the Tax Court, 61 T.C. 1 (1973), that a payment in satisfaction of an apparent liability under § 16(b) of the Securities Exchange Act was properly deductible as an ordinary and necessary business expense.

Reversed.

LOUIS A. BRADBURY, Attorney, Tax Division, Department of Justice, Washington, D.C. (Scott P. Crampton and Meyer Rothwacks, on the brief), *for Appellant.*

GLEN H. KANWIT (Hopkins, Sutter, Owen, Mulroy & Davis, Chicago, Ill.), *for Appellees.*

KAUFMAN, *Chief Judge*:

The interplay of two distinct statutory schemes, often gives rise to some engrossing legal questions. In this case,

we are called upon to consider the relationship of the Internal Revenue Code and the securities laws—in particular, the proper tax treatment of a payment made in satisfaction of an apparent liability under § 16(b) of the Securities Exchange Act.[1] We find that the policies of both statutes support the determination of the Commissioner of Internal Revenue that § 16(b) repayments should be treated as long term capital losses, and reverse the decision of the Tax Court allowing a deduction as an ordinary and necessary business expense.

I.

Unlike those in many tax cases, the facts here are relatively straightforward. Nathan Cummings, chairman of the board and chief executive officer of Consolidated Food Corporation, was offered a large bloc of stock in Metro-Goldwyn-Mayer, Inc. [MGM] during 1959. He was told that the company was experiencing management problems, and that if he would become a director, three members of the board who were involved in controversy would resign. Cummings then purchased 51,500 shares of MGM stock

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[1] In pertinent part, Section 16(b) provides: For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period of exceeding six months. * * * 15 U.S.C. § 78p(b) (1970).

for something more than $1,030,000, and was elected to the board after the three directors resigned.

The price of MGM stock rose, and on April 17, 1961, Cummings sold 3400 shares for a total of $227,648.29. His profit was properly reported as a long term capital gain on the 1961 tax return which he and his wife jointly filed. Between September 18 and October 2, 1961, however, Cummings bought back 3000 shares for $146,960.89. This purchase, within six months after the sale, brought him within the likely purview of § 16(b) of the Securities Exchange Act, making the difference between the sale price and the purchase price, $53,870.81, recoverable by MGM. Cummings was apparently unaware of his liability until soon after MGM, in preparation for its 1962 annual meeting, submitted its proxy material to the Securities and Exchange Commission. On January 16, 1962, the Division of Corporate Finance of the SEC informed Joseph A. Macchia, secretary of MGM, that if Cummings had realized profits from his sale and purchase, that fact would have to be noted in the proxy statement.[2] Macchia promptly communicated this to Cummings and although Cummings believed that any violation, if it did occur, was inadvertent, he nevertheless decided to remit the $53,870.81 to MGM. Cummings testified that the purpose of the payment was to prevent any delay in the issuance of MGM's proxy statement and also to protect his business reputation, which might be injured by a disclosure of his potential liability because of an alleged securities laws violation. The Tax Court gave credence to Cummings's version. In any event, MGM issued its proxy statement dated January 18, 1962.

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[2] *See* 17 C.F.R. § 240-14a-101, Item 7(e), Instruction 4 (1974).

without reference to any potential liability outstanding from Cummings.[3]

Cummings and his wife treated his repayment as a deduction against ordinary income on their 1962 income tax return, but the Commissioner disallowed this and assessed a deficiency of $45,790.18, maintaining that long term capital loss treatment was appropriate.[4] The Tax Court, 60 T.C. 91 (1973) held that the payment was properly characterized as an ordinary and necessary business expense, incurred to protect Cummings's business reputation. After the Court of Appeals for the 7th Circuit reversed a similar Tax Court decision, *James E. Anderson*, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971), the Tax Court reconsidered the case. It affirmed its previous holding, although six judges dissented and one abstained.[5]

II.

We are not required in this case to write on a *tabula rasa*, for the Court of Appeals of two circuits have already rejected the Tax Court's treatment of § 16(b) repayments as ordinary and necessary business expenses. *Anderson*

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[3] On February 1, 1962, Cummings learned of a corporation which had not required repayment of § 16(b) profits by a director who had inadvertently violated the statute. Accordingly, on February 6, he wrote Macchia to request refund of his $53,870.81 payment. On advice of its independent counsel, MGM never made the refund.

[4] Long term capital losses must first be charged against long term capital gains, Int. Rev. Code of 1954 [Code] §§ 1201(b), 1222(5), and then charged against short term capital gains. They are deductible from ordinary income only to the extent of $1000 a year, Code § 1211(b), and may be carried over the five subsequent years. Code § 1212.

[5] The Tax Court found an additional business purpose in Cummings's desire to prevent delay in the issuance of MGM's proxy statement.

v. *C.I.R.*, 480 F.2d 1304 (7th Cir. 1973), *rev'g* 56 T.C. 1370 (1971); *Mitchell* v. *C.I.R.*, 428 F.2d 259 (6th Cir. 1970), *cert. denied* 401 U.S. 909 (1971), *rev'g* 52 T.C. 170 (1969).[6] Our starting point, as was theirs, is *Arrowsmith* v. *C.I.R.*, 344 U.S. 6 (1952), which held that an expenditure made for a business purpose will not be treated as an ordinary and necessary business expense if it is sufficiently related to an earlier capital gains transaction. Since the Commissioner relies heavily on *Arrowsmith*, brief recitation of the facts of that case would aid in the resolution of the legal issue here presented. Two individuals liquidated a corporation which they owned, and paid taxes on their profits at the long term capital gains rate. After the lapse of four years, a judgment was entered against the liquidated corporation which the individuals, as transferees of the corporate assets, were then required to pay. The Supreme Court disallowed deduction of the payment as a business expense, because, the Court reasoned, had the liability been satisfied in the year the corporation was liquidated, the payment would have been applied to reduce the taxpayers' long term capital gain. The payment was thus to be treated as a long term capital loss when it was made four years later.

The *Arrowsmith* rule was explained and applied in *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969). There, a corporation repaid money which it had recorded in an earlier taxable year as income reduced by the 27½% oil depletion allowance. The Court held that the corporation could not deduct 100% of the repayment as a business expense since

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[6] The appeal in Charles I. Brown, T.C. Mem. 1973-275, 32 CCH T.C. Mem. ¶32,258 (1973), a case similar to this one, is pending before the 10th Circuit. Laurence M. Marks, 27 T.C. 464 (1956), the first of the line of Tax Court decisions, was never appealed.

only 72½% of the income had been subject to taxation. *Arrowsmith* was held to forbid the windfall which would result if income taxed at a special lower rate when received were deductible on repayment at a different and more favorable rate.

The nexus between the § 16(b) repayment and the earlier capital gains is apparent. The repayment "had its genesis" in the earlier sale, *see Mitchell,* 428 F.2d at 261, which was a prerequisite for § 16(b) liability. As the *Anderson* court noted, 480 F.2d at 1307, "The amount of liability is calculated by subtracting from the sales proceeds the lowest purchase price within the six-month period" so the repayment may properly be viewed as a return of a portion of the sales proceeds or an adjustment of the sales price. In addition, the capital gain appears to include the profits from the sale and purchase. Cummings experienced a gain in the economic sense when he repurchased the stock at a lower price than that at which it was sold. But the only gain which he recognized for tax purposes was the capital gain on his original sale. Thus, for tax purposes, his payment of $53,870.81 profit from the sale and purchase may appropriately be regarded as an adjustment to the amount of that capital gain.

It is apparent, also, that Cummings would obtain a windfall like that condemned in *Skelly Oil* if we were to treat his § 16(b) repayment as an ordinary and necessary business expense. Both before and after the events at issue he owned the 3000 shares of MGM. In the interim, however, he consummated a sale which resulted in the recognition of a gain and a subsequent repurchase within six months—the combination of which violated § 16(b). The § 16(b) repayment was designed, so far as practicable, to restore the status quo prior to the offending sale and purchase.

We would be remiss, therefore, if we allowed Cummings a windfall which would flow from permitting his gain to be taxed at a lower capital gains rate and his repayment—designed to erase the improper § 16(b) gains—to be deducted at the more favorable ordinary income rate.[7]

The result we reach is supported not only by a proper interpretation of the tax laws, but by the policy of § 16(b) as well. Our longstanding interpretation of that provision, noted over 30 years ago, is that ". . . the statute was intended to be thoroughgoing, to squeeze all possible profits out of stock transactions" within its purview, *Smolowe* v. *Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943) in order to remove the incentive for short-term trading by corporate insiders. It would defeat this policy if insiders could reap a tax advantage by enjoying the low capital gains rate on realized gains while obtaining a deduction against ordinary income when they surrendered those gains in satisfaction of a § 16(b) liability. In this case, for example, Cummings would benefit by $45,790.18 if he were permitted to deduct his repayment as a business expense,[8] although (assuming that he elected the 25% alternate capital gains tax) he paid taxes of only $13,467.70 when he reported the comparable gain in 1961.

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[7] We are cognizant, of course, of Judge Campbell's dissenting opinion in *Anderson*, 480 F.2d at 1309. We believe that our discussion thus far responds to his view that only by improper resort to general equitable considerations, or a desire to bring about statutory symmetry, or the anxiety to implement the enforcement of § 16(b), can one read the tax laws as not permitting § 16(b) repayments to be deductible as business expenses. In our view, the rationale of *Arrowsmith* condemns windfalls no less than does the appropriate interpretation of § 16(b).

[8] Since Cummings already had large capital loss carryovers, the amount of the deficiency is equal to his full tax benefit.

Thus, he seeks to profit by $32,322.48 as a result of his § 16(b) transaction. We agree with the Seventh Circuit that, "Without good reason, we are unwilling to interpret the Internal Revenue Code so as to allow this anomalous result which severely and directly frustrates the purpose of Section 16(b)." *Anderson,* 480 F.2d at 1308, *citing Skelly Oil, supra,* and *Tank Truck Rentals, Inc.* v. *C.I.R.,* 356 U.S. 30 (1958).

Cummings maintains, however, that the statutory policy is irrelevant to this proceeding because he was never adjudicated to be in violation of § 16(b). *See* 61 T.C. at ——. In particular, he notes two possible defenses—that the MGM board had the discretion not to demand repayment of Cummings's insider profits, and that the "opportunity for speculative abuse," described as the keystone of § 16(b) liability in *Kern County Land Co.* v. *Occidental Petroleum Corp.,* 411 U.S. 582 (1973), was lacking because the decision to repurchase was made by Cummings's personal financial assistant.

Even a fledgling securities lawyer would recognize that these "defenses" border on the frivolous. There is no evidence that MGM would not have demanded payment. Moreover, the failure of a board of directors to demand repayment of § 16(b) profits scarcely extinguishes an insider's liability, which may readily be collected in a shareholder derivative action that is inevitable when stock is as widely held as MGM's. Nor is Cummings's reliance on *Kern County* plausible. Suffice to say that that case involved an "unorthodox" transaction, *see* 411 U.S. at 593, in which a company making a takeover bid was forced to exchange its stock when its target engineered a successful defensive merger, a situation hardly comparable to the garden variety sale and purchase which was executed by Cummings.

In any event, we need not conclusively determine that Cummings violated or intended to violate § 16(b) in order to deny him an ordinary and necessary business expense deduction. Section 16(b) is a placid inlet in the chaotic sea of securities law—a statute designed for easy application. The elements of the cause of action are simple, and information about possible violations is widely disseminated. Thus, no proof need be forthcoming that the insider intended at the time he sold to repurchase the securities within six months, or that inside information was actually used. 15 U.S.C. § 78p(b) (1970). To simplify enforcement, corporate insiders are required to make periodic reports to the Commission of transactions in their company's stock. 15 U.S.C. §78p(a) (1970). These reports, summarized monthly, are distributed by the Government Printing Office to about 11,500 subscribers, 39 S.E.C. Ann. Rep. 38 (1973) and seen by many more. Potential § 16(b) liabilities must be described in the company's annual proxy statement, 17 C.F.R. § 240.14a-101, Item 7(e), Instruction 4 (1974). One can hardly imagine a scheme better designed to insure the almost automatic enforcement of a statute, and we decline to subvert it by refusing to squeeze all profits from inside transactions unless liability has been established by a court adjudication.[9]

III.

In viewing Cummings's § 16(b) repayment as a long term capital loss rather than a business expense, we do not

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[9] Nor are we persuaded by Cummings's contention that the statutory purpose is not undercut because favorable business expense treatment would be permitted only if an insider is able to establish a business purpose in making the payment. Virtually every insider who repays his § 16(b) profits will convincingly claim that he did so to protect his business reputation.

ignore a third alternative. As Judge Drennan suggested in his dissenting opinion in the Tax Court, the repayment may be viewed as linked to the repurchase, and treated for tax purposes as an addition to the basis of the purchased stock.[10] The effective net result is that the repayment would be treated as a long term capital loss in the year that the repurchased stock is finally sold.[11] It may be that such treatment would in an appropriate case better effectuate the policy of § 16(b) than that which we adopt today. But, by deferring the tax benefit of a payment currently made, the addition to basis would exact a penalty beyond that specified by Congress from an insider whose violation might be only inadvertent.[12] Since neither party urges adoption of Judge Drennen's formula, however, we decline to resolve the issue.[13]

Reversed.

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[10] A similar result was urged in Lokken, Tax Significance of Payments in Satisfaction of Liabilities Arising Under Section 16(b) of the Securities Exchange Act of 1934, 4 Ga. L. Rev. 298 (1970).

[11] If the stock is sold at a loss, the increase in basis would increase the amount of that capital loss. If the stock is sold at a gain, the increase in basis would reduce that gain—the effective equivalent of a capital loss.

[12] Indeed, similar considerations were the apparent rationale for Laurence M. Marks, 27 T.C. 464 (1956), which departed from the earlier Tax Court rule that § 16(b) repayments would be denied any deduction. Robert Lehman, 25 T.C. 629 (1955); William F. Davis, Jr., 17 T.C. 549 (1951).

[13] Nor need we decide whether Code § 1341 is available to provide relief to the taxpayer whose § 16(b) repayment and resulting long term capital loss occur in a year subsequent to that in which he recognized the capital gain. *See* Lokken, *supra* note 10, at 315-320.

SMITH, *Circuit Judge* (concurring in the result):

I concur in the reversal of the judgment, but respectfully differ from the rationale adopted.

I do not agree that this case is controlled by *Arrowsmith* v. *C.I.R.*, 344 U.S. 6 (1952) and *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969). Both of those cases held that, when income is taxed at a reduced rate when received, it cannot be deducted at a more favorable rate if for some reason it has to be repaid. At the heart of those cases is the repayment of an amount which had previously been included in income. Indeed, in *Skelly Oil*, the Court was doing nothing more than applying a statute, 26 U.S.C. §1341, which by its terms is limited to the repayment of an "item included in gross income in the year of receipt." 394 U.S. at 683.

This case, involving a probable sale and repurchase violation of §16(b), simply does not present that kind of situation. The mere fact that there could be no liability under §16(b) were there not a sale which (in this case) resulted in taxable income is irrelevant, because the money paid out by Cummings to MGM cannot be treated as an item previously included in income. The amount of income on the sale (determined by the difference between the original purchase price and the sale price) has no bearing on the calculation of the insider's profit (determined, roughly, by the difference between the sale price and the repurchase price). In fact, it is perfectly clear that there can be an insider's profit even if the sale resulted in a loss, because the sale assumes relevance for tax purposes only when linked with the original purchase and the repurchase will not have tax significance until a subsequent sale occurs. The sale and repurchase, which result in

§16(b) liability, do not constitute a transaction with any tax significance whatever, and the insider's profit is not income for tax purposes, regardless of whether it may be considered, as my brother Kaufman considers it, as "gain in the economic sense." *Ante* at ——.

I also disagree with the characterization of the payment to MGM as an adjustment to the sale price of the stock. I cannot subscribe to the view that "the capital gain appears to include the profits from the sale and purchase," *ante* at ——, because the transaction resulting in capital gain terminated with the sale, and the purchase was the initiation of a new transaction that should be considered entirely separate and independent for tax purposes. In any event, transactions are to be treated as they actually occurred, not in accord with what might have occurred. *C.I.R.* v. *National Alfalfa Dehydrating and Milling Co.*, —— U.S. ——, 42 U.S.L.W. 4798 (May 28, 1974).

This reasoning applies, of course, only to sale and repurchase violations of §16(b). The tax significance of a purchase and sale violation would be entirely different. In that case, the insider's profit obviously should be treated as the repayment of an amount included in income. But the fact that one kind of violation of §16(b) leads to *Arrowsmith/Skelly Oil* treatment does not require that all kinds of violations of §16(b) be so treated. The income tax provisions of the Internal Revenue Code are not to be construed *in pari materia* with the estate and gift tax provisions, *Farid-es-Sultaneh* v. *Commissioner*, 160 F.2d 812, 814-815 (2d Cir. 1947); there is no more reason why they must be construed *in pari materia* with the 1934 Securities and Exchange Act.

Nor do I think *Tank Truck Rentals, Inc.* v. *C.I.R.*, 356 U.S. 30 (1958) relevant to the litigation before us. That decision—which is to be applied only in a "sharply limited and carefully defined category" of cases, *Commissioner* v. *Tellier*, 383 U.S. 687, 694 (1966)—involved the payment of punitive fines assessed after an adjudication of liability. Since the payment here—made in contemplation of potential liability—was remedial and not punitive, *Feder* v. *Martin Marietta Corp.*, 406 F.2d 260, 266 (2d Cir. 1969); *Adler* v. *Klawans*, 267 F.2d 840, 844 (2d Cir. 1959), this is not an appropriate case for applying a policy designed to avoid the dilution of punishment. *See Tellier, supra*, at 694.

For these reasons, I would not hold that the ordinary loss deduction should be disallowed and treated instead as a capital loss deduction. These transactions should more properly be treated in accordance with the opinion of Judge Drennen below: For tax purposes, the proper treatment would be to add to the repurchase price as the basis for the new shares the amount paid over, and to recognize neither capital gain or loss nor ordinary business expense until the tax year in which the shares are sold.